

Letter of Findings: 10-0183
Sales and Use Tax
For the Years 2006, 2007, and 2008

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ISSUE

I. Sales and Use Tax – Imposition.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-8.1-5-1; [45 IAC 2.2-4-1](#); [45 IAC 2.2-4-2](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer protests the imposition of use tax on its purchases of tangible personal property.

STATEMENT OF FACTS

Taxpayer is an Indiana S Corporation in the restaurant business. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for tax years 2006, 2007, and 2008. Pursuant to the audit, the Indiana Department of Revenue ("Department") determined that Taxpayer failed to properly collect and remit sales tax for tax year 2006. The Department's audit also determined that Taxpayer made several purchases without paying sales tax at the time of the retail transactions or self-assessing and remitting to the Department the use tax accordingly. As a result, the Department's audit assessed Taxpayer additional sales tax, use tax, interest, and penalty.

Taxpayer timely protests the assessment and has submitted additional documentation to support its protest. Taxpayer, however, requested that the Department make its determination based on the documentation it submitted without a hearing. Thus, this Letter of Findings is written based on the documentation provided by Taxpayer and the information available within Taxpayer's protest file. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition.

DISCUSSION

The Department's audit determined that Taxpayer made several purchases without paying sales tax at the time of the transactions, where tangible personal property was transferred to Taxpayer. The Department's audit also found that Taxpayer failed to self-assess and remit the use tax to the Department accordingly. Taxpayer, to the contrary, first asserted that it was not responsible for sales and/or use tax because it had subscribed to non-taxable services. Additionally, Taxpayer claimed that it was entitled to receive manufacturing exemptions for some of the purchases pursuant to IC § 6-2.5-5-3(b). Taxpayer further stated that the Department's audit mistakenly assessed one transaction twice. Taxpayer also asserted that the Department's audit erroneously assessed sales tax on items which it believes were not listed in Taxpayer's general ledger, nor could Taxpayer find the invoices.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A. Unitary Transactions.

The Department's audit assessed use tax on transactions for which Taxpayer failed to pay sales tax at the time when the transactions occurred. Taxpayer asserted that it subscribed to non-taxable services involving transactions for "Odor Neutralizers," "Chairs/Booths Re-upholstery," "Advertising-Design Fee," and "Hats and Tape." To support its protest, Taxpayer provided a summary which listed the disputed items with brief explanations and copies of the invoices concerning those transactions.

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq.

IC § 6-2.5-2-1 provides:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

"Unitary transaction," as defined in IC § 6-2.5-1-1(a), "includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated."

IC § 6-2.5-1-2 states:

(a) "Retail transaction" means a transaction of a retail merchant that constitutes selling at retail as described in [IC 6-2.5-4-1](#), that constitutes making a wholesale sale as described in [IC 6-2.5-4-2](#), or that is described in any other section of [IC 6-2.5-4](#).

(b) "Retail unitary transaction" means a unitary transaction that is also a retail transaction.

IC § 6-2.5-4-1, in pertinent part, provides:

(a) A person is a retail merchant making a retail transaction when he engages in selling at retail.

(b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:

(1) acquires tangible personal property for the purpose of resale; and

(2) transfers that property to another person for consideration.

(c) For purposes of determining what constitutes selling at retail, it does not matter whether:

(1) the property is transferred in the same form as when it was acquired;

(2) the property is transferred alone or in conjunction with other property or services; or

(3) the property is transferred conditionally or otherwise.

[45 IAC 2.2-4-1](#), in relevant part, further explains:

(a) Where ownership of tangible personal property is transferred for a consideration, it will be considered a transaction of a retail merchant constituting selling at retail unless the seller is not acting as a "retail merchant".

(b) All elements of consideration are included in gross retail income subject to tax. Elements of consideration include, but are not limited to:

(1) The price arrived at between purchaser and seller.

(2) Any additional bona fide charges added to or included in such price for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other services performed in respect to or labor charges for work done with respect to such property prior to transfer.

(3) No deduction from gross receipts is permitted for services performed or work done on behalf of the seller prior to transfer of such property at retail.

Nonetheless, [45 IAC 2.2-4-2](#) provides an exception and, in relevant part, states:

(a) Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax. **Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:**

(1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;

(2) The tangible personal property purchased is used or consumed as a necessary incident to the service;

(3) The price charged for tangible personal property is inconsequential (not to exceed 10 [percent]) compared with the service charge; and

(4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.

(b) Services performed or work done in respect to property and performed prior to delivery to be sold by a retail merchant must however, be included in taxable gross receipts of the retail merchant.

(c) Persons engaging in repair services are servicemen with respect to the services which they render and retail merchants at retail with respect to repair or replacement parts sold.

(d) A serviceman occupationally engaged in rendering professional, personal or other services will be presumed to be a retail merchant selling at retail with respect to any tangible personal property sold by him, whether or not the tangible personal property is sold in the course of rendering such services. If, however, the transaction satisfies the four (4) requirements set forth in 6-2.5-4-1(c)(010), paragraph (1) [subsection (a) of this section], the gross retail tax shall not apply to such transaction. (**Emphasis added**).

Notably, a transaction where tangible personal property is transferred in conjunction with a service must satisfy all four requirements to be considered a non-taxable transaction pursuant to [45 IAC 2.2-4-2\(a\)](#). In this instance, Taxpayer's documentation demonstrated that, among those listed transactions, there was no transfer of tangible personal property in the "Advertising-Design Fee" transaction, invoice number 115612, dated September 29, 2006, in the amount of \$150. Therefore, the "Advertising-Design Fee" transaction was considered a non-taxable service. Taxpayer's documentation, however, failed to satisfy the four requirements concerning the transactions of "Odor Neutralizers," "Chairs/Booths Re-upholstery," and "Hats and Tape." Thus, given the totality of the circumstances, in the absence of other documentation, those transactions were considered unitary transactions subject to sales tax pursuant to the above mentioned statutes and regulations. Since Taxpayer did not pay sales tax at the time of the transactions, the use tax is properly imposed.

In short, Taxpayer has provided sufficient documentation to demonstrate that the "Advertising-Design Fee"

transaction was a non-taxable service. Taxpayer, however, failed to provide sufficient documentation concerning the transactions of "Odor Neutralizers," "Chairs/Booths Re-upholstery," and "Hats and Tape."

B. Manufacturing Exemption.

The Department's audit assessed Taxpayer use tax on purchases of tangible personal property. Taxpayer, to the contrary, claimed that it was entitled to claim the manufacturing exemption for its purchases of the tangible personal property, materials for repair, pursuant to IC § 6-2.5-5-3(b).

As discussed previously, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8](#)(a). An exemption from use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

IC § 6-2.5-5-3(b) states:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8](#)(a). Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8](#)(c). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8](#)(c), example 1.

[45 IAC 2.2-5-8](#)(k) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities: pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

[45 IAC 2.2-5-8](#)(d) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

[45 IAC 2.2-5-8](#)(f) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between

plants is taxable, if the plants are not part of the same integrated production process.

[45 IAC 2.2-5-8](#)(g) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced." Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

Accordingly, Indiana has adopted a "double direct" standard to determine whether a taxpayer is entitled to the manufacturing exemption for its purchases. The taxpayer must demonstrate that it is in the manufacturing business and its purchases of tangible personal property are directly used in its direct production process in order to be exempt from sales and/or use tax. In this instance, in addition to copies of the invoices, Taxpayer simply provided a summary list of items with brief explanations that it was entitled to receive the exemption pursuant to IC § 6-2.5-5-3(b). Thus, given the totality of the circumstance, in the absence of other documentation, the Department is not able to agree that Taxpayer has met its burden of proof to demonstrate that it directly used its purchases of tangible personal property in its direct production and, therefore, it was entitled to receive the exemption for its purchases.

In short, Taxpayer failed to demonstrate that it was entitled to receive an exemption for its purchases.

C. Erroneous Assessments.

Taxpayer asserted that the Department's audit mistakenly assessed one transaction twice. Taxpayer also claimed that the Department's audit erroneously assessed use tax on the transactions, which Taxpayer could not find in its general ledger, or could not find the invoices.

Taxpayer first pointed to one of the three "Advertising-Mugs" transactions in the audit summary, dated November 4, 2007, and stated that the transaction is a duplicate to the transaction, dated November 30, 2007.

Notably, according to the Department's audit, it assessed use tax on three "Advertising-Mugs" transactions, in the same amount of \$3,312, from the same vendor, but which occurred separately on November 4, 2007, November 30, 2007, and December 31, 2007. While the Department's audit referred to an invoice (reference number 120662) for the November 4, 2007 transaction, the audit referred to Taxpayer's general ledger for the remaining November 30, 2007 transaction and December 31, 2007 transaction. The information contained in the audit—among the above three transactions, the same vendor invoiced Taxpayer on the same items, in the same amount of \$3,312, with different dates—indicated that Taxpayer routinely purchases the same items from the same vendor for the same amount. Here, Taxpayer simply submitted a copy of the "November 4, 2007" invoice, number 120662, and stated that the transaction is a duplicate to the transaction, dated November 30, 2007. Taxpayer did not explain "how" and "why" the November 4, 2007 transaction indeed was identical to the November 30, 2007 transaction. Upon further reviewing Taxpayer's documentation, the invoice only contained a notation of "paid on November 5, 2007." Taxpayer, however, did not provide any additional documentation which leads to the conclusion that the November 4, 2007 transaction and November 30, 2007 transaction were identical. Thus, the Department is not able to agree that Taxpayer has met its burden demonstrating that the Department's proposed assessment is not correct.

Taxpayer also believes that the Department's audit erroneously assessed two (2) "Odor Neutralizers" transactions, dated December 31, 2007, and December 31, 2008. However, Taxpayer simply stated that "these amounts are not listed anywhere in the general ledger [or] on any invoices from [its vendor]" without providing additional documentation to substantiate its claim. Thus, in the absence of other documentation, the Department is not able to agree that Taxpayer has met its burden of proof that the Department's assessment is not correct.

In short, Taxpayer did not provide sufficient documentation to demonstrate that the Department's assessment on the November 4, 2007 and November 30, 2007 transactions was wrong. Taxpayer also did not provide sufficient documentation demonstrating that the Department's assessment on two (2) "Odor Neutralizers" transactions was incorrect.

FINDING

Taxpayer's protest of Part A is sustained on the "Advertising-Design Fee" transaction. However, Taxpayer's protest of the remaining transactions in Part A is respectfully denied. Taxpayer's protest of Part B concerning its purchases of the materials for repair is respectfully denied. Taxpayer's protest of Part C, the erroneous assessments, is also respectfully denied. The Department will recalculate Taxpayer's tax liability in a supplemental audit.

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